

Private Letter Ruling: Taxpayer factoring company is a financial organization entitled to apportion business income under IITA Section 304(c), and may not be included in a unitary business group with taxpayers who may not apportion their business income under that subsection.

February 9, 2001

Dear:

This is in response to your letter dated January 10, 2001, in which you request a Private Letter Ruling on behalf of xxxxxxxxxxxxxxxxxxxx ("xxx"). Review of your request for a Private Letter Ruling disclosed that all information described in paragraphs 1 through 8 of subsection (b) of 86 Ill. Adm. Code Section 1200.110 appears to be contained in your request. The Private Letter Ruling will bind the Department only with respect to xxx for the issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that xxx and/or any related taxpayer(s) is not currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

The facts and analysis as you have presented them are as follows:

General Information

1. This request for a Private Letter Ruling ("PLR") is prepared by the undersigned who is acting as an agent for our client, xxx, pursuant to an original Form 2848, Power of Attorney, submitted herein.
2. This PLR is not requested with regard to hypothetical or alternative proposed transactions. The PLR is requested to determine the income tax consequences of the actual business practices of xxx.
3. xxx is not currently engaged in litigation with the Department in regard to this or any other tax matter.
4. The Department has not previously ruled regarding this matter for xxx. Neither xxx nor xxxx has submitted the same or similar issues to the Department.
5. xxx requests that certain information be deleted from the PLR prior to dissemination to others. xxx requests that its name, address, location of its headquarters, description of products being sold and the name of its representative be deleted.
6. xxx knows of no authority contrary to the authorities referred to and cited below.

Statement of Material Fact

1. xx (“xxxx”), which is headquartered in Illinois, is a wholly-owned subsidiary of xx (“xxxxxxx”). xxxxxxxxx is a subsidiary of xx (“xxx”), a publicly-traded Japanese corporation.

2. xxxx is engaged in the business of researching, developing, packaging, labeling and marketing pharmaceutical products. xxxx purchases its pharmaceutical products in bulk from xxx.
3. xxxx has a wholly-owned subsidiary, xxx ("xxx"), also headquartered in Illinois, which sells pharmaceutical products to customers throughout the United States.
4. xxx makes credit sales and, therefore, generates accounts receivable in the normal course of its business operations. Some of these credit sales are made to Illinois customers.
5. xxx is a limited liability company headquartered and domiciled in Illinois. xxx is a wholly-owned subsidiary of xxxx and has checked-the-box to be treated as a corporation for federal and state income tax purposes. xxx is a factoring company engaged in the purchase of accounts receivable for cash and without recourse, at an arm's-length discount, from xxx.
6. xxx purchases all of xxxxx accounts receivable at regular intervals for cash at an arm's-length discount. The discount is based on the prevailing market rate of interest at the time the particular receivables are purchased, the expected number of days to collect the particular receivables, the creditworthiness of the customer group and particular customers whose receivables are being purchased and the costs associated with the collection and cash application process.
7. The payments for the accounts receivable are received at a lockbox located in Illinois.
8. Holdings, xxxx and xxx file a combined Illinois income tax return as members of a unitary business group.
9. xxx only has employees in Illinois. xxx only files an income tax return in Illinois. It files a separate Illinois income tax return using a single sales factor since it anticipates that it should be treated as a financial organization under the Illinois income tax statutes.
10. Upon collection of the accounts receivable, xxx uses the cash to purchase additional accounts receivable to the extent receivables are available for purchase.

Rulings Requested

xxx respectfully requests a binding PLR from the Department confirming that:

1. xxx would be treated as a “financial organization” under the Illinois Income Tax Act (“ITA”);

2. xxxxx discount income arising from the factoring of accounts receivable would be treated as interest income under the IITA;
3. xxx would be required, in Illinois, to apportion its total income from the factoring of accounts receivable based upon the following apportionment formula:

Interest income (discount income) receipts received at the Illinois lockbox from xxxxx customers with a commercial domicile in Illinois divided by total interest income (discount income) receipts received;
4. xxx would be required to file a separate Illinois income tax return and would not be included in the xxx unitary return.

Relevant Authorities

Financial Organization Status

IITA Section 1501(a)(8) defines a “financial organization” as follows:

- (A) The term “financial organization” means any bank, bank holding company, trust company, savings bank, industrial bank, land bank, safe deposit company, private banker, savings and loan association, building and loan association, credit union, currency exchange, cooperative bank, small loan company, *sales finance company*, investment company, or any person which is owned by a bank or bank holding company. For the purpose of this Section a “person” will include only those persons which a bank holding company may acquire and hold an interest in, directly or indirectly, under the provisions of the Bank Holding Company Act of 1956 (12 U.S.C. 1841, et seq.), except where interests in any person must be disposed of within certain required time limits under the Bank Holding Company Act of 1956. (Emphasis added.)

Pursuant to Illinois Senate Bill 799, effective January 1, 2000, IITA Section 1501(a)(8) defines a “sales finance company” as follows:

- (C) For purposes of subparagraph (A) of the paragraph, the term “sales finance company” has the meaning provided in the following item (i) or (ii):
 - (i) A person primarily engaged in one or more of the following businesses: the business of purchasing customer receivables, the business of making loans upon the security of customer receivables, business of making loans for the express purpose of funding purchases of tangible personal property or services by the borrower, or the business of finance leasing. For purposes of the item (i), “customer receivable” means:
 - (a) a retail installment contract or retail charge agreement within the meaning of the Sales Finance Agency Act, the Retail Installment Sales Act, or the Motor Vehicle Retail Installment Sales Act;

- (b) an installment, charge, credit, or similar contract or agreement arising from the sale of tangible personal property or services in a transaction involving a deferred payment price payable in one or more installments subsequent to the sale; or
- (c) the outstanding balance of a contract or agreement described in provisions (a) or (b) of this item (i).

A customer receivable need not provide for payment of interest on deferred payments. A sales finance company may purchase a customer receivable from, or make a loan secured by a customer receivable to, the seller in the original transaction or to a person who purchased the customer receivable directly or indirectly from the seller.

The definition of a sales finance company contains a “primarily” test describing the activities in which a sales finance company may be engaged. The Department of Revenue, in the Practitioners’ Liaison Group Questions and Answers, clarified that “primarily,” in IITA Section 1501(a)(C)(i), means greater than 50%. xxx is primarily in the business of purchasing customer receivables from xxx. The accounts receivable purchased arise from xxxxx sale of pharmaceutical products and thereby meet the definition of a customer receivable under the IITA. Because xxx is primarily engaged in the business of purchasing customer receivables, we believe xxx would be considered a sales finance company, and as such, a financial organization for purposes of the IITA.

Income Characterized as Interest Income

Under IITA Section 1501(a)(8), a sales finance company is included within the definition of a financial organization. As a financial organization, xxx would apportion its income to Illinois based on IITA Section 304(c).

IITA Section 304(c) apportions interest from Illinois customers. The IITA does not define the term interest. However, pursuant to IITA Section 102, the meaning for which a term is used for purposes of the Internal Revenue Code shall be the same meaning used for purposes of the IITA, unless expressly provided otherwise. For federal income tax purposes, the United States Supreme Court has defined “interest” to mean “compensation for the use of forbearance of money.” *Deputy v. du Pont*, 308 U.S. 488, 498 (1940).

xxx purchases, on an ongoing basis, accounts receivable from xxx at a discount. The discount at which the accounts receivable are purchased takes into consideration the prevailing market rate of interest at the time of sale, the due date of the accounts receivable, the creditworthiness of the customers and the costs associated with collections. xxx purchases the accounts receivable at a price which reflects all factors typically considered in determining interest to be paid for the advancement of funds. So to the extent that xxx collects payments in excess of the amount paid for the accounts receivable, we believe that amount should be considered compensation for the use of xxxxx money and, as such, would be classified as interest and sourced under IITA Section 304(c)(1)(C) for purposes of apportioning xxxxx business income to Illinois.

Sourcing of Interest Income

Under IITA Section 304(c)(1)(C), interest income is sourced to Illinois only if it is from an Illinois customer and received in Illinois. The term “customer” is not defined in the IITA or in any relevant authority, and therefore we request a ruling that the obligors on the accounts receivable become the customers of xxx. While there is no statutory or regulatory guidance on this issue, the Department previously issued a private letter ruling in a similar case that raised the same issue. See Ill. Priv. Ltr. Ruling 98-007. In that case, the Department determined that when a factoring company purchased accounts receivable from an affiliated corporation, the corporation’s customers became the factoring company’s customers. The Department based its conclusion on the fact that the factoring company actually bought the accounts receivable, rather than making a loan to the affiliated corporation. In this case, xxx purchases, on the ongoing basis, accounts receivable from xxx at an arm’s-length discount. After the purchase of the receivables, xxx finances and services the accounts receivable, and therefore those obligors are customers of xxx.

Another issue to be resolved is the meaning of “Illinois customer” and “received in Illinois”. Again, there is no statutory or regulatory definitions of these terms. However, in Illinois Private Letter Ruling 98-007, the Department provided detailed guidance to a particular taxpayer on these issues. In that letter ruling, the Department concluded that the interest income would be allocated to Illinois if:

- (a) the customer is:
 - (i) an individual Illinois resident; or
 - (ii) a person (other than an individual) whose commercial domicile is in Illinois; or
 - (iii) (subject to rebuttal) any person whose billing address is in Illinois if xxx has no knowledge of the person’s residence or commercial domicile; and
- (b) the customer’s payment is:
 - (i) sent by the customer to a lockbox in Illinois; or
 - (ii) transmitted by the customer electronically to a bank located in Illinois.

Therefore, xxxxx business income should be apportioned to Illinois based on an apportionment formula, the numerator of which is the sum of interest income received at an Illinois lockbox and/or by electronic transmittal to a bank located in Illinois from xxxxx customers that are residents of Illinois, commercially domiciled in Illinois or, where xxx has no knowledge of residence or commercial domicile, persons whose billing addresses are in Illinois, and the denominator of which is the sum of all interest income received from all sources.

Duty to File a Separate Illinois Return

IITA Section 502(a)(2) provides:

A return with respect to the taxes imposed by this Act shall be made by every person for any taxable year:

- (1) For which such person is liable for a tax imposed by this Act, or
- (2) In the case of a resident or in the case of a corporation which is qualified to do business in this State, for which such person is required to make a federal income tax return, regardless of whether such person is liable for a tax imposed by this Act ...

xxx has customers in Illinois. xxx purchases accounts receivable from xxxxx Illinois customers, thereby having business income sourced to Illinois under IITA Section 304(c) and is required to file a return under IITA Section 502(a)(1). Since xxx should be a sales finance company and therefore a financial organization for purposes of the IITA, it is required to apportion its income using the apportionment formula for financial organizations in IITA Section 304(c). The xxx unitary group apportions its business income according to the guidelines provided for general corporations in IITA Sections 304(a) and (h). IITA Section 1501(a)(27) provides that:

In no event, however, will any unitary business group include members which are ordinarily required to apportion business income under different subsections of Section 304 except that for years ending on or after December 31, 1987 this prohibition shall not apply to a unitary business group composed of one or more taxpayers all of which apportion business income pursuant to subsection (b) of Section 304, or all of which apportion business income pursuant to subsection (d) of Section 304, and a holding company of such single-factor taxpayers...

xxx, as stated above, should be required to apportion its income under IITA Section 304(c). The xxx unitary group apportions its income under IITA Sections 304(a) and (h). Therefore, according to IITA Section 1501(a)(27), since xxx apportions income under IITA Section 304(c), we believe it is barred from being a member of xxxxx unitary business group and is required to file a separate Illinois income tax return.

Conclusions

The following summarizes xxxxx conclusions with respect to the company's activity in the state of Illinois as analyzed under the IITA:

1. xxxxx business activities in Illinois are consistent with that of a financial organization by virtue of being a sales finance company as defined in the IITA.
2. xxxxx income from the factoring of accounts receivable would be considered interest income under the IITA Section 304(c).
3. xxxxx discount income would be treated as interest income and apportioned to Illinois based upon interest receipts received at an Illinois lockbox from xxxxx customers with a commercial domicile in Illinois divided by the total interest receipts received.
4. xxx is required to file a separate Illinois income tax return.

Ruling

Qualification of xxx as a Financial Organization

Section 1501(a)(8) of the Illinois Income Tax Act (the "IITA"; 35 ILCS 5/101 *et seq.*) defines the term "financial organization" as follows:

(A) The term "financial organization" means any bank, bank holding company, trust company, savings bank, industrial bank, land bank, safe deposit company, private banker, savings and loan association, building and loan association, credit union, currency exchange, cooperative bank, small loan company, sales finance company, investment company, or any person which is owned by a bank or bank holding company. For the purpose of this Section a "person" will include only those persons which a bank holding company may acquire and hold an interest in, directly or indirectly, under the provisions of the Bank Holding Company Act of 1956 (12 U.S.C. 1841, *et seq.*), except where interests in any person must be disposed of within certain required time limits under the Bank Holding Company Act of 1956.

* * *

(C) For purposes of subparagraph (A) of this paragraph, the term "sales finance company" has the meaning provided in the following item (i) or (ii):

(i) A person primarily engaged in one or more of the following businesses: the business of purchasing customer receivables, the business of making loans upon the security of customer receivables, the business of making loans for the express purpose of funding purchases of tangible personal property or services by the borrower, or the business of finance leasing. For purposes of this item (i), "customer receivable" means:

(a) a retail installment contract or retail charge agreement within the meaning of the Sales Finance Agency Act, the Retail Installment Sales Act, or the Motor Vehicle Retail Installment Sales Act;

(b) an installment, charge, credit, or similar contract or agreement arising from the sale of tangible personal property or services in a transaction involving a deferred payment price payable in one or more installments subsequent to the sale; or

(c) the outstanding balance of a contract or agreement described in provisions (a) or (b) of this item (i). A customer receivable need not provide for payment of interest on deferred payments. A sales finance company may purchase a customer receivable from, or make a loan secured by a customer receivable to, the seller in the original transaction or to a person who purchased the customer receivable directly or indirectly from that seller.

You have represented that all of the business activities of xxx are related to the purchase of customer accounts receivable from xxx. Under Section 1501(a)(8)(C) of the IITA, xxx shall therefore be considered a sales finance company, which is a financial organization for purposes of the IITA.

Apportionment of Business Income of xxx

Section 304(c)(1) of the IITA provides the basic apportionment rule for financial organizations, as follows:

Business income of a financial organization shall be apportioned to this State by multiplying such income by a fraction, the numerator of which is its business income from sources within this State, and the denominator of which is its business income from all sources. For the purposes of this subsection, the business income of a financial organization from sources within this State is the sum of the amounts referred to in subparagraphs (A) through (E) following, but excluding the adjusted income of an international banking facility as determined in paragraph (2):

- (A) Fees, commissions or other compensation for financial services rendered within this State;
- (B) Gross profits from trading in stocks, bonds or other securities managed within this State;
- (C) Dividends, and interest from Illinois customers, which are received within this State;
- (D) Interest charged to customers at places of business maintained within this State for carrying debit balances of margin accounts, without deduction of any costs incurred in carrying such accounts; and
- (E) Any other gross income resulting from the operation as a financial organization within this State. In computing the amounts referred to in paragraphs (A) through (E) of this subsection, any amount received by a member of an affiliated group (determined under Section 1504(a) of the Internal Revenue Code but without reference to whether any such corporation is an "includible corporation" under Section 1504(b) of the Internal Revenue Code) from another member of such group shall be included only to the extent such amount exceeds expenses of the recipient directly related thereto.

As this statutory provision is structured, a financial organization apportions its business income by first identifying each item of business income which is described in paragraphs (A) through (D). Those items are sourced to Illinois according to the applicable rule in paragraph (A), (B), (C) or (D), and all other items of business income are sourced to Illinois under the rule in paragraph (E). The total of items sourced to Illinois is then divided by the total of all business income of the taxpayer from all sources, and the result is multiplied by the taxpayer's business income to determine the amount apportioned to Illinois.

You have requested a ruling that the amounts received by xxx from customers of xxx, to the extent those amounts exceed the amounts paid by xxx for the respective accounts receivable purchased from xxx, will be sourced under Section 304(c)(1)(C) as interest income.

For federal income tax purposes, the United States Supreme Court has defined "interest" to mean "compensation for the use or forbearance of money." *Deputy v. du Pont*, 308 U.S. 488, 498 (1940). Pursuant to Section 102 of the IITA, this definition of the term "interest" for purposes of the Internal Revenue Code also applies to the term "interest" as used in the IITA. As you have described the transactions by which xxx will acquire the accounts receivable from xxx, xxx will acquire all rights to payments on the receivables and will assume all responsibility for collection of the receivables, for a cash price determined by the prevailing market rate of interest at the time of sale, the due date of the accounts receivable, the creditworthiness of the customers and the costs associated with collections. Accordingly, the amounts received by xxx from xxxxx customers in excess of the amounts it has paid for the respective accounts receivable will be compensation received entirely in exchange for the use of xxxxx money and will reflect the factors normally taken into account in determining the amount of interest payable on an advance of funds. Such amounts will therefore be interest for purposes of the IITA, and their allocation will be governed by Section 304(c)(1)(C) of the IITA.

Under Section 304(c)(1)(C) of the IITA, interest income is sourced to Illinois if it is from an Illinois customer and received in Illinois. The term "customer" is not defined in the IITA or in any relevant authority, and the definition is the proper subject for rulemaking. However, pending the promulgation of a regulatory definition, under the facts described in your request, the obligors on the accounts receivable will be customers of xxx. The obligors are all customers of xxx, which will be making credit sales in the expectation of selling the accounts receivable to xxx. Because xxx is affiliated with xxx and will be buying the accounts receivable (rather than making a loan to xxx secured by the accounts receivable) in transactions fully anticipated at the time the accounts receivable are created, the obligors on the accounts receivable will become customers of xxx at the time the accounts receivable are sold.

The term "Illinois customer" also is not defined in the IITA or in any relevant authority, and is also the proper subject for rulemaking. Pending the promulgation of regulations on this issue, the following principles should be applied. First, the term "Illinois customer" will include any individual customer who is a resident of Illinois and any person (other than an individual) who is commercially domiciled in Illinois. Second, if the taxpayer has no actual knowledge of the residence or commercial domicile of a customer, the customer will be presumed (subject to rebuttal) to be an Illinois customer if the billing address of the customer is in Illinois.

The term "received in this State" in Section 304(c)(1)(C) of the IITA is undefined, and is the proper subject for rulemaking. Pending promulgation of regulations on this issue, interest from xxxxx Illinois customers will be "received in this State" if the payment is sent by the customer to a lockbox located in Illinois or the electronic funds transfer from the customer is directed to an account of xxx at a bank located in Illinois.

In summary, the amounts xxx receives from obligors on accounts receivable purchased from xxx in excess of the amounts paid by xxx for the accounts receivable will be interest income which will be sourced to Illinois if:

- (a) the customer is:

- (i) an individual Illinois resident; or
 - (ii) a person (other than an individual) whose commercial domicile is in Illinois; or
 - (iii) (subject to rebuttal) any person whose billing address is in Illinois if xxx has no knowledge of the person's residence or commercial domicile; and
- (b) the customer's payment is
- (i) sent by the customer to a lockbox in Illinois; or
 - (ii) transmitted by the customer electronically to a bank located in Illinois.

Note that payments made by a credit card company (or any other third party) on behalf of a customer are payments from the customer, and should be sourced according to the same rules as payments made directly by the customer.

Duty of xxx to File an Illinois Return

Section 502(a)(2) of the IITA provides:

A return with respect to the taxes imposed by this Act shall be made by every person for any taxable year:

- (1) For which such person is liable for a tax imposed by this Act, or
 - (2) In the case of a resident or in the case of a corporation which is qualified to do business in this State, for which such person is required to make a federal income tax return, regardless of whether such person is liable for a tax imposed by this Act
- ...

xxx receives interest payments in Illinois from Illinois customers, requiring the apportioning of income to Illinois, and thus creating an income tax liability on its Illinois income for which a return must be filed under Section 502(a)(1) of the IITA. Further, xxx is headquartered and commercially domiciled in Illinois. xxx is therefore required under Section 502(a)(2) to file an Illinois income tax return if it is required to make a federal return, regardless of whether xxx has an income tax liability under the IITA.

Since xxx is a sales finance company, and thus a financial organization for purposes of the IITA, xxx shall be required to use the apportionment formula for financial organizations under IITA Section 304(c). Section 1501(a)(27) of the IITA provides that:

... In no event, however, will any unitary business group include members which are ordinarily required to apportion business income under different subsections of Section 304 except that for years ending on or after December 31, 1987 this prohibition shall not apply to a unitary business group composed of one or more taxpayers all of which apportion business income

pursuant to subsection (b) of Section 304, or all of which apportion business income pursuant to subsection (d) of Section 304, and a holding company of such single-factor taxpayers ...

xxx, as stated above, will be required to apportion income under Section 304(c). xxx currently apportions income under separate subsections of Section 304, specifically subsections (a) and (h). Thus, according to Section 1501(a)(27), xxx and xxx are barred from being members of the same unitary business group, and xxx will be required to file a separate return from that of xxxxx unitary business group.

The facts upon which this ruling are based are subject to review by the Department during the course of any audit, investigation or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

Very truly yours,

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